NEW ZEALAND LAW SOCIETY

NZLS EST 1869

TAXATION (ANNUAL RATES FOR 2016-17, CLOSELY HELD COMPANIES, AND REMEDIAL MATTERS) BILL

01/08/2016

SUBMISSION ON THE TAXATION (ANNUAL RATES FOR 2016-17, CLOSELY HELD COMPANIES, AND REMEDIAL MATTERS) BILL

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on the Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Bill (Bill). The headings in this submission correspond to the relevant headings of the Minister of Revenue's *Commentary on the Bill* (Commentary). Reference is also made, where appropriate, to Inland Revenue's *Regulatory Impact Statements* (RIS), which accompanied the introduction of the Bill. All statutory references in this submission are to the Income Tax Act 2007 (Act) unless otherwise specified.

2. The Law Society's comments address the following matters in the Bill:
   - A. Closely-held companies
   - B. NRWT: related party and branch lending
   - C. GST current issues
   - D. Other policy matters:
     - Related parties debt remission
     - Double Tax Agreements (DTAs)
     - Land tainting and Council Controlled Organisations
     - Time bar and ancillary taxes

A. Closely-Held Companies

Look-through company eligibility criteria (cl 262)

3. Clause 262 of the Bill proposes various amendments to the definitions of "look-through company", "look-through counted owner" and "look-through interest" in section YA 1 of the Act. These proposed amendments tighten the eligibility criteria for a company to be a look-through company (LTC). In particular, these proposed changes:

   - impact on the way in which beneficiaries of a trust are counted when determining whether the "5 or fewer look-through counted owners" test is met;
   - preclude tax charities and Māori authorities from being LTC owners, either directly or indirectly via a trust;
   - preclude trusts that hold shares in LTCs from making distributions to corporate beneficiaries; and

- limit the amount of foreign income that an LTC can derive where more than 50% of the ownership interests in the LTC are held by "foreign LTC holders" (as defined).

4. The justification provided in the Commentary and the RIS for tightening the LTC eligibility criteria seems to be that persons who could not have a direct or indirect interest in a qualifying company (QC) should not be entitled to have a direct or indirect ownership interest in an LTC. The Law Society does not agree with this justification for tightening the LTC eligibility rules. In particular, the Law Society notes that, when the LTC rules were introduced, the LTC eligibility criteria were deliberately drafted differently from the QC eligibility criteria. Given the drafting differences, it is fair to infer that Parliament intended that LTCs would be able to be used more widely than QCs.

5. The proposed tightening of the LTC eligibility criteria will impose substantial compliance costs and tax costs on taxpayers who elected into the LTC regime in good faith and based on policy settings that applied at the time the LTC regime was introduced. Compliance costs will include costs in reviewing and amending trust deeds for LTCs with trustee shareholders, costs in monitoring compliance with the new LTC eligibility criteria (the transitional rules for counting beneficiaries of trustee shareholders are particularly complex and compliance intensive) and costs of restructuring where it is not possible to comply with the new LTC eligibility criteria. In addition, tax costs will arise where LTCs are forced to restructure because they do not meet the new LTC eligibility criteria.

6. The Law Society also notes that the proposed changes to the definitions of "look-through company", "look-through counted owner" and "look-through interest" do not meet the stated policy objective. For example:

   - Proposed paragraph (eb) of the definition of "look-through company" only prohibits a trustee shareholder of an LTC from making a distribution <u>of income</u> to a corporate beneficiary. The Commentary and the RIS state that this restriction should apply to all amounts, not just income, distributed by a trustee shareholder.

   - Proposed paragraphs (ec) and (ed) of the definition of "look-through company" make reference to a "tax charity". A "tax charity" is defined in section CW 41(5) of the Act (but only for the purpose of sections CW 41, CW 42 and CW 43). Not all charities will be "tax charities". In particular, charitable organisations that choose not to register as a charitable entity under the Charities Act 2005 will not be "tax charities". It is unclear why the proposed changes to the definition of "look-through company" should apply to "tax charities" and not charities generally, particularly as the Commentary and the RIS refer to charities generally, and not just "tax charities".

Recommendation

7. That the proposed amendments to the definitions of "look-through company", "look-through counted owner" and "look-through interest" do not proceed, as they will impose significant compliance costs and tax costs on taxpayers who formed LTCs in good faith based on the policy settings that were in place at the time the LTC regime was enacted. Alternatively, the Law Society recommends that the proposed LTC eligibility criteria apply only to companies that elect to become LTCs after the date the Bill is enacted. If neither of these recommendations is accepted, then the Law Society recommends that transitional provisions are enacted to enable existing LTCs to restructure without a tax cost (consistent with the transitional provisions that were put in place when the LAQC regime was repealed).

Deduction limitation rule (cl 105)

8. The Law Society welcomes the proposed changes to the deduction limitation rule, which previously imposed substantial compliance costs on LTCs where there was no (or little) corresponding risk to the tax base.

Debt remission (cls 13, 56, 104 and 119)

9. The Law Society welcomes the proposal concerning self-remission income for fiscally transparent entities, but is concerned that the proposal does not work as intended.

10. The Commentary states that the proposal ensures that <u>remission income does not arise</u> to an LTC owner / partner who remits a debt owed to them by the LTC / partnership. The proposed amendment does not, however, have this effect.

11. The proposal is effected in the Bill by amending the definition of "amount remitted" in section EW 31(11) of the Act to exclude "self-remission", which is essentially the amount for which the person is, by the operation of the fiscal transparency principle, both lender and borrower.

12. The definition of "amount remitted" (both current and as proposed) is an amount that is not included in the consideration paid or payable <u>to</u> the person because it has been remitted. It follows that the "amount remitted" item in the base price adjustment formula never comes into play when undertaking a base price adjustment for a borrower, because remission does not affect the amount payable <u>to</u> the borrower.

13. Because the "amount remitted" item does not include the amount that is not payable <u>by</u> a borrower because it has been remitted, the fact that self-remission is excluded has no effect on the base price adjustment performed by the shareholder in their capacity as the LTC owner / borrower. As such, the

proposal does not prevent remission income arising to an LTC owner or partner for debt remitted by them.

14. When the LTC owner undertakes a base price adjustment in their capacity as lender, the self-remission amendment does come into play. The amount remitted which is added back excludes the self-remission amount, so the shareholder ends up with financial arrangement expenditure under the base price adjustment for the self-remitted amount. If that expenditure is deductible, the deduction offsets the remission income, and they are effectively in the same position as if there was no remission income. However, this outcome is dependent on the financial arrangement expenditure being deductible in the first place.

15. In considering whether financial arrangement expenditure arising under a base price adjustment is deductible, the interest deductibility rules and section DB 11 of the Act come into play, rather than section DB 31 of the Act. There is nothing in the Bill that changes this. If the financial arrangement expenditure is not deductible, then the proposed change does not achieve its objective.

16. To achieve the proposed policy outcome (i.e. that remission income does not arise in the case of self-remission), it would make more sense to introduce a further item into the base price adjustment formula which, for a borrower, subtracts self-remission amounts. This would retain the lender's position as it is now, but achieve the intended policy objective of preventing remission income arising to the borrower.

17. Under this proposal, the base price adjustment formula would be

consideration – income + expenditure + amount remitted <u>– self-remission</u>

18. A new definition of "self-remission" would also need to be added, which would refer to the amount which is not included in the consideration paid or payable <u>by</u> the person because it has been remitted by the person or by law, to the extent to which, because of the operation of section HB 1 or section HG 2 of the Act (which relate to LTCs and partnerships), the person is also entitled as creditor in their capacity of owner or partner.

Recommendation

19. That the base price adjustment formula in section EW 31 of the Act is amended as set out above to ensure that remission income does not arise to an LTC owner / partner who remits a debt owed to them by the LTC / partnership.

Qualifying companies (cls 98 and 262)

20. The Commentary and RIS note that QCs have certain tax advantages over other companies. The Law Society is concerned that this does not create a level playing field, as taxpayers can no longer elect for a company to become a QC. The Law Society considers that the proposal in the Bill to deal with "trading" in QCs by introducing continuity of ownership rules in the QC eligibility criteria does not deal with the real issue, which is the lack of a level playing field.

21. The Law Society recommends that consideration be given to repealing the QC regime, but at the same time amending the definition of "dividend" in subpart CD of the Act so that "close companies" would be able to distribute amounts (including non-cash amounts) tax-free to shareholders (and not just on liquidation), to the extent that the distribution is not a fully-imputed cash distribution. This would create a level playing field, as all "close companies", not just QCs, would be able to make distributions in this manner.

22. Should this proposal proceed, then the definition of "close company" would need to be amended to grandparent existing QCs and also to ensure that companies in which one or more trusts hold 50% or more of the voting or market value interests are not automatically disqualified from being treated as "close companies". The Law Society suggests that where shares in a company are held by one or more trusts a "count test", similar to that used in the current QC regime or the LTC regime, is used to determine the number of shareholders.

Recommendation

23. That, instead of introducing a shareholder continuity requirement in the QC qualification criteria, consideration is given to repealing the QC regime on the proviso that subpart CD of the Act is amended so that non-cash distributions and unimputed dividends made by "close companies" (as redefined) will be able to be distributed to shareholders tax-free.

Tainted capital gains (cl 23)

24. The Law Society welcomes the proposed relaxation of the so-called "tainted capital gain" rule. Clarification may, however, be required in terms of the effective date of the new rules. The Commentary notes that "The amendments will come into force on the date of enactment and applied to <u>distributions</u> made on or after that date." (at page 21). The Law Society agrees with this, as the issue of whether a capital gain is able to be distributed tax-free only arises on liquidation, and then only if the company has amounts to distribute on liquidation in excess of its available subscribed capital. As such, where a company derives a capital gain before the Bill is enacted, but that capital gain is distributed after the Bill is enacted, determination of whether that gain is a "tainted capital

gain" should be based on the new rules, not the old rules that were in effect on the date the capital gain was derived. This should be made clear in a Tax Information Bulletin (and Special Report if one is issued) following the enactment of the Bill.

25. Consideration should be given to whether the proposed rule relating to transfers of property between companies with 85% or more commonality of ownership should apply to "close companies". The Law Society considers that such a rule is not appropriate for "close companies", which should be taxed in a manner consistent with direct ownership of property. If this proposal is adopted, consideration should also be given to the definition of "close company", which currently excludes companies in which 50% or more of the shares are held by one or more trusts.

Recommendations

26. That clarification be provided in a Tax Information Bulletin (and Special Report if one is issued) following the enactment of the Bill that the determination of whether a capital gain is a "tainted capital gain" for gains derived prior to the enactment of the Bill, but distributed after the enactment of the Bill, should be based on the new rules and not the old rules.

27. That consideration be given to amending the proposed inter-company transfer provision, so that it will not apply to "close companies", and that the definition of "close companies" is amended so that companies in which 50% or more of the shares are held by one or more trusts are not automatically disqualified from being "close companies".

RWT on dividends (cls 239 – 242)

28. The Law Society welcomes the proposed changes to the rules relating to RWT on dividends paid to a corporate shareholder. The Law Society notes that the Commentary and the RIS make reference to dividends paid to corporate shareholders within the same wholly-owned group of companies being exempt from RWT (section RE 2(5)(a)(i) of the Act). The Law Society notes that this exclusion extends to dividends paid to a corporate shareholder in the same group of companies, whether or not that group is a wholly-owned group (section RE 2(5)(g) of the Act).

PAYE on shareholder-employee salaries (cls 234, 235, 236 and 262)

29. The Law Society welcomes the proposed changes to shareholder-employee salaries, which will enable certain companies to pay a mix of PAYE-deducted salary and non-PAYE deducted salary to shareholder-employees.

30. The Law Society notes the retrospective "minor technical amendments" that have been proposed to section RD 3 of the Act. While the Commentary states that "These do not alter the scope of section

RD 3" (page 27), this does not appear to be the case. In particular, the replacement of the term "a shareholder-employee of a close company" with "a shareholder, and an employee, of a company that is a close company or has 25 or fewer shareholders" in section RD 3(2) means that LTCs would, as a result of the retrospective amendments, be able to pay non-PAYE deducted shareholder salaries to LTC shareholders who are also employees. Based on the current wording of section RD 3 this is not possible, as while an LTC is treated as a "company" for the purpose of the PAYE rules, it is not treated as a "close company" (that definition not being part of the PAYE rules) and, therefore, could not choose to pay a non-PAYE deducted salary to a shareholder-employee. This has been a major impediment to a number of LTCs. The Law Society recommends that the change in the ability of an LTC to pay a non-PAYE deducted salary to a shareholder who is also an employee, as a result of the retrospective amendments to section RD 3, be noted in the Tax Information Bulletin (and Special Report if one is issued) accompanying the enactment of the Bill.

31. Given that the proposed retrospective amendments to section RD 3 will enable an LTC to pay a non-PAYE deducted salary to a shareholder who is also an employee (up to the date that provision is replaced by the proposed new rule), it is not clear why the rules in proposed sections RD 3B and RD 3C of the Act, which provide additional flexibility for structuring remuneration for shareholder-employees, should not be available to LTCs. The Law Society recommends that proposed sections RD 3B and RD 3C are redrafted so that they can also apply to LTCs.

Recommendations

32. That it is clarified that the proposed retrospective amendments to section RD 3 of the Act enable an LTC to pay a non-PAYE deducted salary to a shareholder who is also an employee.

33. That consideration be given to enabling LTCs to apply the proposed new rule, which will enable companies to pay a mix of PAYE-deducted salaries and non-PAYE deducted payments to shareholders who are also employees.

B. NRWT: Related party and branch lending (clauses 5, 15, 55, 83, 246 – 248, 252, 253, 261, 262, 269, 270, 294, and 330 – 333)

General comment – application date for the new rules should be pushed back

34. New Zealand's current non-resident withholding tax (NRWT) and approved issuer levy (AIL) rules were enacted more than twenty years ago with the aim of reducing the costs that New Zealand borrowers faced in raising funds from offshore. Historically, the rules have been relatively simple to apply and the use of the AIL regime has been popular.

35. The rules outlined the Bill will significantly change how the NRWT and AIL rules operate in New Zealand, and will affect a large number of taxpayers. They will introduce considerable complexity in an area that was previously well understood. This complexity will increase compliance costs for taxpayers, and will increase the likelihood of future non-compliance with the rules. In addition, in some instances the proposed change, as currently drafted, may result in overreach (for example, AIL may not be available in relation to lending between unrelated parties).

36. At present it is proposed that the new rules will generally come into operation from the date that the Bill is enacted, with limited grandfathering available for certain existing lending arrangements. However, given the complexity of the new rules and the number of taxpayers that will be affected, the application date of the new rules should be pushed back, to allow some of the complexities to be addressed.

Interest on related party lending proposals (cls 236 to 260)

37. The provisions in the Bill dealing with NRFAI (non-resident financial arrangement income) refer in a number of places to "person A" and "person B". These references are confusing. It appears that these terms are defined in draft section RF 2B, and then used in other sections (e.g. RF 12D) without reference back to the section RF 2B or to a standardised definition (for instance in section YA 1).

Recommendation

38. That standardised definitions for the two parties (for instance, "borrower" and "lender") are added to section YA 1 of the ITA to avoid confusion, and that these definitions are substituted in place of references to "person A" and "person B".

Reference to "non-resident owning body" (clause 253)

39. The reference to "non-resident owning body" in draft section RF 12H(1)(a)(iii) appears to be to the wrong provision (section RF 12I(3) instead of RF 12I(4)). It also appears superfluous as under proposed section RF 12I(5) a non-resident owning body is generally treated as being an associated person (meaning that section RF 12I(1)(a)(i) would apply).

Recommendation

40. That proposed section RF 12H(1)(a)(iii) is removed.

Apportionment of interest paid to New Zealand sources (clause 270)

41. The proposed amendments to section YD 4 and YD 5 of the ITA assume that it will be possible to trace foreign funds applied to New Zealand use. Tracing could be difficult if money is borrowed for various different purposes at various different times from various different lenders.

42. Difficulties in tracing how money is used may also mean that a borrower may not have the option of withholding NRWT in many cases.

Recommendation

43. That the amendments to sections YD 4 and YD 5 of the ITA are considered further.

AIL registration proposals (clauses 328 to 335)

Rules on registration of securities are currently too narrow (clause 330)

44. Clause 330 of the Bill sets out a replacement section 86G for the Stamp and Cheque Duties Act 1971, which sets out who can register securities for the purposes of the approved issuer levy (AIL) regime. The replacement section imposes significant restrictions on the persons that can register securities for AIL purposes.

45. The Law Society understands that the purpose of the restrictions is to prevent the AIL regime being accessed by associated parties. However, it is concerned that in some instances the replacement section may also result in unassociated persons being unable to access the AIL regime (which we assume would be unintended).

46. Say, for example, a New Zealand borrower obtained funds from an unrelated non-resident lender that is not widely held. Assuming that the borrower is not a person who as of right can register securities (as set out in replacement section 86(G)(2)) and that annual interest paid under the loan is $500,000 or less (meaning that replacement section 86(G)(3) will not apply) the loan can only be a registered security if the lending transaction itself involves money lent by a financial institution that lends to the public as part of its business and has more than 100 outstanding loans (see replacement section 86(G)(3)(b)).

47. Even if the non-resident lender does operate a lending business with more than 100 outstanding loans it may not qualify as a "financial institution" (which is defined using the Income Tax Act 2007 definition of that term) because it will not be a New Zealand registered bank or subject to the Deposit Takers (Credit Ratings) Regulations 2009 (which have been repealed). This would mean that the borrower may be unable to register the loan despite it being with an unrelated party.

48. While it should be relatively simple to address that particular issue (by deleting the "financial institution" wording from replacement section 86(G)(3)(b)), the above example is just one example of the potential overreach the replacement registration rules currently have.

49. Another example of overreach could arise if a New Zealand borrower borrowed funds from an unassociated non-resident person that was an individual or a closely held business. If the interest payments were not over the $500,000 per annum threshold, there would be no access to the AIL regime, despite there being no association between borrower and lender.

50. The Law Society acknowledges that the registration rules provide the Commissioner with the ability to issue determinations to cover additional situations where persons are able to register securities. However, it would be better if the draft wording of section 86G was reconsidered before the new rules are enacted.

Recommendation

51. That the drafting of replacement section 86G be reconsidered to ensure that the AIL regime remains available to unassociated parties as intended. The words "financial institution" should also be deleted from replacement section 86G(3)(b) and replacing with the word "person" (i.e. "…money lent by a person…").

Use of determinations to address gaps in the proposed amendments (clause 330)

52. The provision for determinations (in proposed section 86G(3)(d) amending the Stamp and Cheque Duties Act 1971 and section 91AAU amending the Tax Administration Act) to fill gaps in the draft legislation does not provide adequate certainty in regard to the new rules and is not an appropriate mechanism to address the significant issues identified in this submission.

Recommendation

53. That the issues identified with the proposed legislation be addressed in the legislation rather than ad hoc by determination at a later date.

C. GST Current Issues

Services Relating to Land in New Zealand

GST land zero-rating provision and procurement of leases (cl 310(5))

54. The current drafting of subclause (iii) of the proposed new section 11(8D)(c) is problematic. The relevant supplies of the interest in land under the lease agreements are unlikely to meet the

requirements of section 11(1)(mb), having regard to section 11(8D)(b). This is because, in the normal course, commercial leases do not involve significant premiums or similar upfront payments.

55. Bearing in mind the primary purpose of section 11(8D)(c) is to facilitate zero-rating of asset and business sales in which the vendor's leasehold interest in business premises cannot be assigned (but the vendor arranges with the landlord to grant a new lease to the business purchaser), the Law Society assumes the provision is not intended to be restricted to situations where the relevant leases involve the payment of premiums.

Recommendation

56. That subclause (iii) of the proposed new section 11(8D)(c) should be worded as follows:

> *"(iii) the supplies of the interest in land under the lease agreements meet the requirements set out in subsection (1)(mb), disregarding paragraph (b) of this subsection."*

57. The Law Society also assumes that the reference at page 74 of the Bill Commentary to ensuring the transactions targeted by section 11(8D)(c) are "standard rated" is an error, and that the reference should be to “zero-rated”.

GST zero-rating of non-profit body acquisitions that include land (cl 310(6))

58. The proposed provision relates back to section 11(1)(mb)(i) of the GST Act, which refers to "goods".

Recommendation

59. That the two references to "land" in proposed section 11(8D)(d) should be replaced with "goods".

GST zero-rating of services in connection with land (cl 311(1) and (3))

60. The drafting of the proposed changes to the zero-rating provisions for services supplied in connection with land in section 11A(1)(e) and (k) of the GST Act could be improved, as shown in the mark-up below. In particular, the suggested changes are intended to:

- maintain the distinction between services supplied "directly in connection with" land and improvements and other services "in connection with" land and improvements covered by the changes; and

- clarify the types of services "in connection with" land and improvements intended to be covered by the changes.

Recommendation

61. That clause 311 be amended as follows:

> ***"311 Section 11A amended (Zero-rating of services)***
>
> *(1) Replace section 11A(1)(e) with:*
>
> *(e) the services are:*
>
> *(i) supplied directly in connection with ~~a parcel of~~land situated outside New Zealand, or with an improvement to such land:~~, or~~*
>
> *(ii) ~~are~~supplied in connection with a particular parcel of land situated outside New Zealand, or with an improvement to any such parcel of land,~~such land or improvement~~ and ~~are~~intended to enable or assist a change, or prospective change, ~~in~~to the physical condition, or the ownership or other legal status, of ~~the~~that parcel of land or improvement; or*
>
> *…*
>
> *(3) Replace section 11A(1)(k)(i) and (ii) with:*
>
> *(i) ~~services which are~~supplied directly in connection with a particular parcel of land situated in New Zealand, or with an improvement to any such parcel of land:~~, or are~~*
>
> *(ii) supplied in connection with a particular parcel of land situated in New Zealand, or with an improvement to any such parcel of land,~~such land or improvement~~ and ~~are~~ intended to enable or assist a change, or prospective change, ~~in~~to the physical condition, or the ownership or other legal status, of ~~the~~that parcel of land or improvement:~~; or~~*
>
> *(iii) ~~services which are~~supplied directly in connection with moveable personal property, other than choses in action or goods to which paragraph (h) or (i) applies, situated in New Zealand at the time the services are performed:~~; or~~*
>
> *(i~~ii~~v) the acceptance of an obligation to refrain from carrying on a taxable activity, to the extent to which the activity would have occurred within New Zealand;"*

62. Even if such drafting changes are adopted, there will still be substantial uncertainty in relation to identifying services that are supplied "*in connection with*" a parcel of land or an improvement to a parcel of land and are "*intended to enable or assist*" a relevant change in respect of the parcel of land or improvement.

63. For example, in relation to legal services provided to non-residents who have invested, or are looking to invest, in New Zealand, clarification will be required in relation to:

- legal services relating to the disposal or acquisition, or proposed disposal or acquisition, of land and/or buildings or other improvements in New Zealand;

- legal services relating to leases, licences, mortgages and other such rights or interests in respect of land and/or buildings or other improvements in New Zealand;

- legal services relating to the procurement of physical works in respect of New Zealand land, including buildings, infrastructure and other improvements, and associated services (eg, architectural, design and engineering services); and

- legal services relating to investing in New Zealand, including structuring advice and implementation of investment structures.

64. Clarification will also be required in relation to various general and property-specific services supplied to non-residents by other service providers, including real estate agents, property managers, architects, designers and engineers, and property valuers.

65. Inland Revenue will need to issue very detailed guidelines to enable service providers to determine whether or not the services they supply are supplied "in connection with", and "intended to enable or assist" a relevant change to, land or improvements.

66. The Law Society notes Inland Revenue's acknowledgement that the changes may have a potential negative impact on competitive neutrality as between domestic and offshore suppliers of services to non-residents in connection with New Zealand land. The post-implementation impact of the changes in this regard should be scheduled for review.

67. The Law Society also reiterates its previous submission, in response to the original proposal in Inland Revenue's September 2015 issues paper, *GST – Current Issues*,[1] that Inland Revenue should ensure that there is consistency as between the zero-rating provisions relating to services supplied in connection with land and services supplied in connection with other goods.

GST and sales in satisfaction of debt (cl 306(1) and 323)

68. The Law Society is concerned that the current drafting of the proposed new section 51B(1)(b) does not achieve what is intended.

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1 http://www.lawsociety.org.nz/__data/assets/pdf_file/0006/96360/l-IRD-GST-Issues-Paper-4-11-15.pdf

69. The primary drafting issue is that the proposed new section 51B(1)(b)(i) provides that the security holder is treated as GST registered even where a sale by the debtor would not have been a taxable supply and the debtor has correctly and fully stated the reasons why. Similarly, the security holder is treated as GST registered if it meets the test in section 5(2)(b). Accordingly, the way the proposed 51B(1)(b)(i) interrelates with section 5(2) needs to be corrected.

70. A further drafting issue (setting aside the primary issue noted above) is that the proposed section 51B(1)(b)(i) does not clearly shift the deemed registration from the security holder to the debtor in circumstances where the debtor has provided a section 5(2)(a) statement that is, on the face of it, full and correct, but is deliberately false. The Law Society submits that the security holder should be able to rely on a statement that is ostensibly credible. If a false statement is given by the debtor, section 51B(1)(b) should apply to the debtor, not the security holder.

Recommendation

71. That new section 51B(1)(b) should be redrafted along the following lines:

> *"(b) if goods are supplied by a sale to which section 5(2) applies,-*
>
> *(i) the person selling the goods, if:*
>
> *(A) the requirements of section 5(2)(a) are not met (unless the person has been furnished with and relied upon a statement falsely indicating that those requirements are met); and*
>
> *(B) the person either does not make the determination referred to in section 5(2)(b) or makes that determination on the basis of information that is not reasonable; or*
>
> *(ii) the person whose goods are sold, if subparagraph (i) does not apply:"*

D. Other Policy Matters

Related parties debt remission

Pari passu concept

72. In QB15/01 “Income tax: tax avoidance and debt capitalisation” the Commissioner opined that arrangements involving the capitalisation of shareholder loans might constitute arrangements that had the purpose or effect of avoiding debt remission in circumstances where there is no change to the shareholder’s interest in the company. The Commissioner also suggested that a similar conclusion might be reached where capitalisation did change the existing shareholder’s (or

shareholders') interest (i.e. capitalisation of third-party debt) where the relevant company was insolvent.

73. The Law Society perceives that an aim of the proposed amendments in respect of related parties' debt remission is to relieve the consequences of the analysis contained in QB15/01.

74. In the Law Society's submission there is a mismatch between the concept of pari passu debt remission adopted in the proposed s EW 46C (clause 57) and the concept of pro rata debt capitalisation referred to in QB15/01, which means that this intention will not be achieved in certain circumstances. Assuming that the purpose of the proposed amendments is as stated above, this purpose is not achieved to the extent that debt would be pro rata debt for the purposes of QB15/01 that does not come within the proposed definition of pari passu debt in s EW 46C(4)(d).

75. For example, the Law Society notes that whether related party debt held by a person is pari passu for the purposes of s EW 46C is determined only by reference to:

- the debt held by that person as a proportion of all debt that is held by all persons who have both debt and equity interests in the debtor (referred to in the draft legislation as Creditor Group Members); and

- the equity interest held by that person in the debtor as a proportion of all equity interests held by all Creditor Group Members.

76. The definition is satisfied where a person's debt proportion as described at (a) corresponds with the person's equity proportion as described at (b).

77. However, QB15/01 appears to take the view that debt capitalisations in respect of related party debt will be tax avoidance where there is no change in the effective ownership in the debtor and existing shareholders suffer no dilution of their investment (leaving aside for now the suggestion in QB15/01 that such capitalisations might yet constitute tax avoidance where the debtor is insolvent).[2]

[2] The position is further complicated by the statements in "Related parties debt remission: An officials' issues paper" and Policy and Strategy's "Technical analysis of certain related parties debt remission" suggesting that in order for income treatment in respect of debt remission to be deactivated, the relevant debt must be both:

(a) held pro rata to ownership; and

(b) remitted pro rata to ownership interests.

78. Take for instance, a Company C with two shareholders, A and B each holding 50 shares. Company C has no debts or assets other than loans of $100 and $130 from A and B respectively.

79. A and B would be Creditor Group Members for the purposes of s EW 46C. But their debts would not be pari passu debts. For example, A's member debt to equity would be 100/50 or 2/1 and B's would be 130/50 or 2.6/1. Neither of these would correspond to the debt to equity proportion of all Creditor Group Members (which would be 230/100 or 2.3/1). So if $50 of each of A's and B's debt was remitted, Company C would have debt remission income of $100.

80. However, if this debt was instead to be capitalised, there would be no alteration in the relative shareholdings of A and B. Therefore, this capitalisation would prima facie be tax avoidance on the analysis in QB15/01.

81. In the Law Society's view neither of these outcomes would be appropriate. On either outcome the total value of each of A and B's investments in Company C (including debt and equity interests) remains unchanged, as does A and B's relative shareholding. No debt remission income should arise.

Recommendation

82. The concept of pari passu debt should be expanded to ensure that it includes all related party debts that, if capitalised, would constitute tax avoidance on the analysis in QB15/01 (or alternatively, the analysis in QB15/01 should be restricted).

Debt held and <u>forgiven</u> in proportion to ownership

83. The Commentary to the Bill is clear that the proposed amendments are intended to operate to prevent debt remission income arising in circumstances where debt is "held and remitted" pro-rata to ownership (page 103 of the Commentary). The concept of "pari passu debt" is described at page 105 of the Commentary as being debt that is both "held and forgiven" in proportion to ownership.

84. The requirement that debt be forgiven in proportion to ownership is not clearly expressed in proposed section EW 46C (clause 57 of the Bill). Subsection (1) contains the preconditions to the application of the remainder of the section. Paragraph (c) requires that the relevant debt owed to the creditor is a pari passu debt, and paragraph (d) that <u>the</u> debt is forgiven. The definition of pari passu debt in subsection (4)(d) defines the relevant debt by reference to a particular creditor group member. Whether the debt meets the definition of "pari passu debt" is determined before the point of remission.

85. The combination of these factors permits a situation where debt is pari passu debt of a creditor group member immediately before the act of remission and that debt is remitted without other creditor group members likewise remitting their pari passu debt interests. Such debt would be pari passu debt in terms of subsection (1)(c) that is remitted in terms of (1)(d).

86. If the intention expressed in the Commentary is to be carried into the operation of the proposed section it is necessary (among other possible solutions) to:

- incorporate at subsection (1)(d), or as a new (e), a requirement that all creditor group members remit the same proportion of the debt; or
- incorporate a requirement in the definition of pari passu debt at subsection (4)(d) that the debt continues to be pari passu debt following remission (the solution being less effective if the remission is complete as opposed to partial).

Debt capitalisation in insolvency

87. The proposed amendments do not deal with the issue of non-pro rata debt capitalisation.

88. In the officials' issues paper "Related parties debt remission" (February 2015) at [2.20] the Commissioner notes anecdotal evidence that following the publication of QB15/01, insolvent companies with outstanding shareholder debt tend to be either liquidated or retained in their insolvent state. The paper suggests that neither of these approaches provide an appropriate solution.

89. If the bias towards liquidation that arises as a consequence of the avoidance analysis in QB15/01 is an undesirable policy outcome in the context of a pro rata debt capitalisation, the Law Society notes that the same bias towards liquidation exists in the context of non-pro rata debt capitalisations in respect of an insolvent company. In the Law Society's submission, this outcome should be seen as similarly undesirable.

Recommendation

90. That officials consider either introducing legislation to overcome the consequences of QB15/01 in respect of debt capitalisations in insolvency, or reconsider the analysis therein.

Bad debt deductions for amounts attributable to assessable income from a financial arrangement

91. The Commentary states that the proposed section DB 31(2)(bb) (clause 41) will deny bad debt deductions that would otherwise arise under section DB 31(2) in respect of debt that could be remitted tax free under the new section EW 46C.

92. However, the Law Society perceives a drafting error in section DB 31(2)(bb) that would have the effect of denying any deduction under section DB 31(2) unless the creditor has an ownership interest in the debtor. Specifically, the proposed drafting of section DB 31(2)(bb) appears to restrict the operation of section DB 31(2) to circumstances where the creditor is a member of the debtor's creditor group (in terms of s EW 46C).

Recommendation

93. If the aim is to restrict bad debt deductions under section DB 31(2) to circumstances where section EW 46C does not have effect (which the Law Society considers to be a logical position), the Law Society recommends that proposed section DB 31(2)(bb) be re-drafted along the following lines

> (bb) where the person is a member of the debtor's creditor group, the assessable income is derived from a financial arrangement that is not pari passu debt

Double Taxation Agreements (DTAs)

Proposed amendment to section BH 1 (clause 6)

94. New Zealand is obliged under Articles 26 and 27 of the Vienna Convention on the Law of Treaties to perform its obligations under its DTAs in good faith, without invoking the provisions of its domestic law as justification for its failure to perform a treaty.

95. The Regulatory Impact Statement 9 "Relationship between double tax agreements and anti-avoidance rules" (RIS 9) states that the proposed amendment would not lead to a breach of New Zealand's obligations under its DTAs on the basis that the application of section BG 1 to deny treaty benefits is consistent with the OECD Commentary to the Model Convention.

Relevance of the OECD Commentary

96. It is generally accepted that the OECD Commentary is relevant to the interpretation and application of a DTA based on the Model Convention. However, this conclusion is usually founded on the proposition that parties negotiating a DTA based on the OECD Model Convention will be aware of the Commentary in existence at the time the negotiation takes place and can be taken as intending for the DTA to be interpreted in accordance with that Commentary. Significantly, this proposition does not hold in respect of Commentary published after a DTA is concluded, of which parties cannot have been aware. In these circumstances the relevance of the OECD Commentary is debatable.

97. RIS 9 draws two principles from the OECD Commentary to justify Inland Revenue's position that the proposed amendment would not contravene New Zealand's obligations under international law. These principles are:

- that states are not required to grant treaty benefits where the relevant DTA has been abused; and
- that "substance-over-form" doctrines applicable under domestic law do not conflict with treaty obligations on the basis that such rules merely determine the facts which give rise to a tax liability to which the relevant DTA then applies.

98. The former principle appears to be derived from amendments made to the OECD Commentary in 2003. The latter appears to be derived from amendments made to the OECD Commentary in 1992.

99. However, it is also important to note that from 1977 to 2003, in addition to the latter principle introduced in 1992, the OECD Commentary also contained a statement to the effect that the operation of domestic anti-avoidance laws would need to be specifically provided for in DTAs.

100. In light of the 2003 amendments to the OECD Commentary, there seems little scope to argue that benefits under DTAs that were concluded after 2003 could not be justifiably denied in appropriate circumstances.

101. However, it remains an open question as to the position in respect of DTAs concluded prior to this date. Whether the OECD Commentary would permit the application of section BG 1 to deny benefits under a DTA concluded prior to 2003 would turn on the following issues:

- whether DTAs concluded prior to 2003 should be interpreted consistently with the 2003 amendments to the Commentary with respect to DTA abuse; and if not
- whether the relevant Commentary at the time the DTA was concluded would permit such application.

102. With respect to the first issue in particular it is noted that there is a general consensus among academics and other expert commentators that DTAs should be applied consistently with later Commentary where the later Commentary serves to clarify Commentary existing at the time the DTA was concluded, but not where the later Commentary contradicts this earlier Commentary. However,

there is a lack of consensus as to which of these two categories the 2003 amendments fall into, and therefore whether the first principle cited in RIS9 can apply in respect of pre-2003 DTAs.[3]

103. It is also doubtful that either principle could apply in respect of DTAs entered into prior to 1992.

Potential limits on application of section BG 1

104. To the extent that the potential application of section BG 1 to a DTA is justified on the basis that domestic substance-over-form doctrines do not conflict with DTAs because they merely determine the facts to which the relevant DTA then applies, it will also be necessary to consider the inherent limits of this approach.

105. Such an approach would seem to be ineffective in circumstances where a particular benefit was sought in reliance on a DTA provision, the application of which did not depend on a specific characterisation under New Zealand's domestic law. For example, Article 10(5) of the United States – New Zealand DTA provides that for the purpose of that article, whether an amount paid by a company constitutes a dividend turns on classification of that amount under the domestic law of the state in which the company is tax resident. If an amount was paid by a United States resident company and if United States law treated this amount as a dividend, it is doubtful that a substance-over-form doctrine operating at a domestic law level in New Zealand could, by itself, apply to treat this amount as anything other than a dividend. Any denial of treaty benefits in these circumstances would need to be justified by reference to an anti-abuse principle inherent in DTAs.[4] For reasons given above, it is by no means settled as to whether such a principle exists in DTAs entered into prior to 2003.

106. Inland Revenue's commentary on the proposed amendment does not acknowledge or address the possibility of any limitation on the application of section BG 1 in a DTA context in the context of pre-2003 DTAs.

An inherent anti-abuse principle

107. It is acknowledged that the application of section BG 1 to deny treaty benefits obtained pursuant to a tax avoidance arrangement could alternatively be justified by reference to a general abuse of rights

3 For example, see the differing conclusions in Craig Elliffe "Cross Border Tax Avoidance: Applying the 2003 OECD Commentary to Pre-2003 Treaties" [2012] BTR 307 and David A Ward and others *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model* (International Fiscal Association, Kingston (Ontario), 2005) at 90.

4 This would appear to be the conclusion reached in Craig Elliffe *International and Cross-Border Taxation in New Zealand* (Thomson Reuters, Wellington, 2015) at 6.10.3.

doctrine under international law (such doctrine being related to the principle cited above that treaties must be applied in good faith).

108. However, it is noted that in this area as well there does not appear to be a consensus among expert commentators as to whether this doctrine could apply to deny benefits, in circumstances where a DTA was entered into at a time when existing OECD Commentary stated that domestic anti-avoidance laws would need to be included in DTAs in order to remain operative.[5]

Recommendation

109. That the proposed amendment to section BH1 be deferred until there has been more extensive consultation on the effect and potential implications of the change, including the effect of the proposed amendment on New Zealand's international law obligations, and that such consultation should expressly acknowledge and address:

- the lack of consensus as to the interaction between domestic anti-avoidance rules and DTAs in relation to DTAs entered into prior to 2003;
- the position in respect of DTAs entered into prior to 1992; and
- the potential for the proposed amendment, if applied in respect of pre-2003 DTAs, to contravene New Zealand's obligations under the Vienna Convention.

Land Tainting and Council Controlled Organisations

Local authority group exclusion from tainting provisions in land tax rules (cl 12)

110. The Law Society considers that the drafting of the proposed local authority group exclusion from the tainting provisions in sections CB 9(2), CB 10(2) and CB 11(2) of the Act could be improved, as shown in the mark-up below. In particular, the suggested changes are intended to:

- make it clear that the exclusion may apply to disposals not only by Council Controlled Organisations (CCOs) and other local authority-controlled entities but also by local authorities (if the income tax exemption under section CW 39(2) would not apply to the disposal); and
- remove the additional references to a CCO or entity being "controlled" by a local authority (which imply greater than 50% control, whereas the CCO control tests and the commentary on the Bill indicate that joint (50/50) control should be sufficient).

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5 David A Ward and others *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, above no 2, at 90-92.

Recommendation

111. That clause 12 of the Bill be amended as follows:

> *"Exclusion~~s~~ for ~~bodies controlled by~~ local authorit~~ies~~y groups*
>
> ***CB 15C ~~Council-controlled organisations and other companies~~ Local authority groups***
>
> *Sections CB 9(2), CB 10(2), and CB 11(2) do not apply to a person (**person A**) despite the activities of an associated person (**person B**) if—*
>
> *(a) person A is ~~a local authority or~~—*
>
> *(i) a local authority:*
>
> *(ii) an entity that is, in relation to a local authority:*
>
> *(A) a council-controlled organisation ~~that is controlled by the~~ of the local authority:*
>
> *(~~ii~~iB) an entity of a type referred to in section 6(4)(a) to (ca) of the Local Government Act 2002~~,~~ that ~~is controlled by the~~ would be a council-controlled organisation of the local authority if it were not an entity of that type:*
>
> *(~~iii~~vC) an entity that is associated with the local authority other than under section YB 14 (Tripartite relationship); and*
>
> *(b) person B is—*
>
> *(i) the relevant local authority referred to in **paragraph (a)(ii)** or an entity that is, in relation to the relevant local authority ~~or an organisation or entity of a type~~ referred to in **paragraph (a)(i) ~~to~~ or (iii)**, an entity of a type referred to in **paragraph (a)(ii)(A) to (C)**:*
>
> *(ii) a person that is not associated with person A other than under section YB 14 (Tripartite relationship)."*

112. The Law Society notes Inland Revenue's recognition of the overreach of the tainting provisions in sections CB 9(2), CB 10(2) and CB 11(2) of the Act (as discussed in Inland Revenue's Regulatory Impact Statement) and supports the inclusion of a review of the scope of the exclusions from the provisions on the tax policy work programme, to ensure that the provisions do not unnecessarily catch disposals of land held on capital account in other contexts.

Time bar and ancillary taxes (clause 295)

113. The Law Society supports the proposed amendments to section 108(1) of the Tax Administration Act 1994 (the Act) (all statutory references under this heading are to the Act, unless otherwise specified) to clarify that the time bar applies to ancillary taxes and the approved issuer levy (AIL). However, we

are concerned that these amendments may only have limited effect, particularly in an AIL/NRWT context, if Parliament does not address section 108(2)(b).

114. Section 108(2)(b) provides that the Commissioner may amend an assessment at any time to increase the amount assessed if (emphasis added):

> *The Commissioner is of the opinion that a tax return provided by a taxpayer…**does not mention income which is of a particular nature** or was derived from a particular source, and in respect of which a tax return is required to be provided*.

115. The Law Society is concerned that there is insufficient guidance on the meaning of the "particular nature" of an amount in a withholding tax context.

116. It seems clear that section 108(2)(b) should be concerned with whether or not an amount is interest, a dividend, or a royalty, and not with the character of the recipient for tax purposes (or, indeed, the circumstances surrounding the receipt or payment). In an AIL/NRWT context, section 108(2)(b) should not apply where a taxpayer who has paid interest discloses the payment as interest in its AIL return provided that the payment remains interest. In particular, it should be clarified that arguments about the status of the recipient as an associate, and therefore whether NRWT applies instead of AIL, should not prevent section 108(1) applying.

117. We suspect few, if any, taxpayers have disclosed anything more to Inland Revenue about their interest payments. Accordingly, if the "particular nature" of an amount were to include any other matters, such as:

- the characteristics of the payee; and/or
- circumstances surrounding the payment;

then the policy intent of the amendments to section 108(1) would not be achieved where it turns out the parties are associated and NRWT becomes payable in lieu of AIL.

118. This issue is not confined to AIL. If "particular nature" were to include the characteristics of the payee and circumstances surrounding the payment, then a taxpayer who:

- applies a treaty-reduced rate of NRWT in the mistaken belief that the recipient is entitled to treaty benefits; and
- fails to disclose the particulars of the payee and the circumstances surrounding the payment (again, these are unlikely to have been disclosed);

it would always be open for the Commissioner under section 108(2)(b) to assess the taxpayer on the basis a higher rate of NRWT applies, notwithstanding the amendments to section 108(1).

Recommendation

119. That section 108(2)(b) be amended to clarify that “particular nature” does not include the characteristics of payees, or the circumstances surrounding an amount.

120. In addition, now that AIL returns are effectively treated as NRWT returns for the purposes of section 108(1), further amendments should also be made to confirm that AIL returns are NRWT returns for the purposes of:

- Section 109 of the Act. If this amendment is not made, it would be open for the Commissioner to challenge a tax position taken by a taxpayer in an AIL return outside of the mechanisms in parts 8 and 8A. This would not be consistent with the treatment of AIL returns as NRWT returns for time bar purposes; and

- The tax pooling provisions in the Act and the Income Tax Act 2007. Under the current rules a taxpayer may be prevented from accessing tax pooling where they have applied the AIL regime, on the basis that their AIL returns did not include an assessment of NRWT. From a policy perspective, there is no reason why a taxpayer should be denied the right to access tax pooling in this case. Amending the tax pooling rules to treat AIL returns as NRWT returns would address this problem.

Conclusion

121. The Law Society does not wish to be heard, but is available to meet with officials advising on the Bill if the Committee considers that this would be of assistance.

Kathryn Beck
President

1 August 2016